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In the Supreme Court of the United States

OCTOBER TERM, 1995

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASS'N, ETC., PETITIONER

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, ETC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the federal receiver's repudiation of future obligations under a failed savings institution's subordinated debentures stripped those debentures of their subordinated status, and elevated claims for damages for the repudiation to the same priority on liquidation as debts owed to the institution's general creditors.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A11) is reported at 63 F.3d 900. The order and judgment of the district court (Pet. App. A12-A14) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 22, 1995. The petition for a writ of certiorari was filed on November 20, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Congress created the Resolution Trust Corporation (RTC) in part to receive and liquidate the assets

of failed savings institutions. See generally 12 U.S.C. 1441a(b), enacted by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183. To that end, Congress granted the RTC the "same powers and rights to carry out its duties with respect to [certain federally insured depository] institutions * * * as the Federal Deposit Insurance Corporation [(FDIC)] has under sections 1821, 1822, and 1823 of [Title 12 of the United States Code]." 12 U.S.C. 1441a(b)(4)(A). Section 1821(c)(1) of Title 12 authorizes the FDIC to act as the receiver for failed savings institutions, and Section 1821(e)(1) provides that the receiver may, among other things, "repudiate any contract * * * to which such institution is a party," if the receiver determines that performance of the contract would be "burdensome" and that repudiation "will promote the orderly administration of the institution's affairs." On December 31, 1995, the RTC's statutory mandate terminated, and the FDIC succeeded to the RTC's role as receiver or conservator in pending proceedings. 12 U.S.C. 1441a(m)(1). The FDIC has therefore been substituted as the respondent in this case.

2. In June, 1987, Santa Barbara Savings and Loan Association issued a series of subordinated debentures with an aggregate face amount of $25 million. Petitioner served as trustee on behalf of the holders of the debentures.[1] Most of the debentures were later converted to stock in Santa Barbara Savings, leaving

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[1] The original trustee, Security Pacific National Bank, later merged with petitioner Bank of America National Trust and Savings Association. The merger had no effect on the matters at issue in this case, and we refer to both parties interchangeably as "petitioner."

outstanding debentures with an aggregate face amount of $8.4 million. Pet. App. A3 & n.1.

The original offering circular for the subordinated debentures indicated that the proceeds of the offering were to be used to increase Santa Barbara's "regulatory capital." Pet. App. A58. At the time the debentures were issued, the Federal Home Loan Bank Board set, by regulation, certain minimum capital levels that depository institutions were required to maintain, in order to ensure that those amounts would be available to absorb losses and to pay depositors and other creditors. See 12 U.S.C. 1464(s) (1988); see also, *e.g.*, 53 Fed. Reg. 51,801 (1988). Those regulatory capital requirements served in part to protect the federal deposit insurance fund, and to "reduce the 'moral hazard' engendered when the [federal] insurer bears most of the cost of a[n] [institution's] failure." *Ibid.*

Federal regulations permitted insured institutions to include, as part of their regulatory capital, the proceeds from the sale of certain subordinated debt securities, principally on the ground that "subordinated debt meeting the requirements of the regulation ha[d] some of the characteristics of other types of permanent capital," such as common stock, and therefore similarly reduced the risk to the federal deposit insurance program. 54 Fed. Reg. 34,149 (1989). In order to qualify as regulatory capital, the funds had to be borrowed under an instrument that "[c]learly state[d] that the [debt would be] subordinated on liquidation, as to principal, interest, and premium, if any, to all claims (including post-default interest) against the institution having the same priority as savings account holders or any higher priority." 12. C.F.R. 563.8-1(d)(1)(ii)(a) (1987). Ac-

cordingly, the terms of the debentures at issue in this case provided that they were to be subordinated (see Pet. App. A4), and that the subordination would "in no way be affected, modified, waived or revoked by the occurrence of any Event of Default." Indenture § 4.02, at 24. The indenture agreement defined the term "Event of Default" to include, among other things, the passage of thirty days after any order appointing a receiver, conservator, or liquidator for Santa Barbara Savings. *Id.* § 9.01, at 44.

In 1990, the Office of Thrift Supervision (OTS) determined that Santa Barbara Savings had insufficient capital to continue operations. The OTS therefore appointed the RTC first as conservator, and shortly thereafter as receiver, of Santa Barbara Savings. Pet. App. A4, A59. In June 1990, the RTC, as receiver, repudiated the debentures and the associated trust indenture agreement. *Id.* at A4, A60. The repudiation relieved the receiver from any obligation to pay, out of Santa Barbara's assets, any future interest that would otherwise have accrued on the debentures. Holders of the debentures continued, however, to have a claim for the amount of their principal investment, together with interest accrued and unpaid on the date the receiver was appointed. See 12 U.S.C. 1821(e)(3). Petitioner, acting on behalf of the debenture holders, filed proof of such a claim with the RTC, seeking damages for the repudiation. The issue in this case is the priority to be accorded to that claim on the liquidation of Santa Barbara's remaining assets.

3. When the FDIC is forced to liquidate a failed savings institution, allowed claims against the institution's assets are paid according to priorities established by statute and regulation. All claims in any one priority "tier" must be provided for before

any claim of lesser priority is paid; when the institution's assets are insufficient to pay all claims of a particular priority, the claims in that tier are paid pro rata, and no payment is made on any junior claim. 12 C.F.R. 360.3(d) (1995).

Three of the priority tiers are particularly relevant here. Tier One encompasses the administrative expenses of the receivership estate. 12 C.F.R. 389.11(a)(1) (1990).[2] Tier Six includes claims by depositors (or by a federal insurer as their subrogee, see 12 U.S.C. 1821(g)), and "all other claims which have accrued and become unconditionally fixed on or before the date of default." 12 C.F.R. 389.11(a)(6) (1990). Tier Nine includes "[c]laims that have been subordinated in whole or in part to general creditor claims," and specifies that such claims "shall be given the priority specified in the written instruments that evidence such claims." 12 C.F.R. 389.11(a)(9) (1990).

A regulation in effect during 1989 and 1990 provided that any claim for damages arising from the receiver's repudiation of an executory contract entered into by the insolvent institution was to be "classified as a claim that has accrued and become unconditionally fixed on or before the date of default, and not as an administrative expense of the receiver." 12 C.F.R. 389.11(c) (1990). When the RTC did not allow petitioner's claim within the waiting period prescribed by law (see 12 U.S.C. 1821(d)(5)), petitioner filed this action in the district court, asserting that its claim for damages caused by the repudiation of the subordinated debentures should not be subordinated to

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[2] For simplicity, we cite the version of the regulations in effect in 1990, when the RTC repudiated the agreement involved in this case.

the claims of Tier Six general creditors, but rather should share in any distributions made to the creditors in that tier.

4. The district court agreed with petitioner that 12 C.F.R. 389.11(c) (1990) required that the claim for damages for repudiation of the subordinated debentures be accorded the same priority as the claims of Santa Barbara's general creditors, including the federal deposit insurance fund as subrogee of the association's insured depositors. Pet. App. A13. The court held that Section 389.11(c)'s reference to classification as a claim that has "accrued and become unconditionally fixed on or before the date of default" was a direct reference to the same language in Section 389.11(a)(6), and required that claims covered by subsection (c) be classified in Tier Six, whatever their other characteristics. See Pet. App. A22-A30 (rejecting various government arguments).

The court of appeals reversed. Pet. App. A1-A11. The court first observed (*id.* at A7) that subordinated debt "[g]enerally * * * stays subordinated to the claims of general creditors upon the insolvency of the institution where the subordinated debt served as regulatory capital." In the court's view, "[t]here would not be much point to subordination, or to allowing subordinated debentures to be used as regulatory capital, if this were not so." *Id.* at A7-A8. The court then rejected petitioner's argument that the similar language of Sections 389.11(a)(6) and 389.11(c) required that any claim arising from repudiation be treated as a Tier Six claim. Pet. App. A8-A11. The court noted (*id.* at A8-A9) that some claims that had "accrued and become unconditionally fixed on or before the day of default," such as certain federal tax claims and subordinated debts that had

matured before the date the receiver was appointed, were nonetheless assigned priorities lower than that of general creditors by the more specific terms of Section 389.11(a)(8)-(10).

The court of appeals also rejected petitioner's argument that the RTC's repudiation of the debentures and the associated trust indenture deprived the subordination provisions of any effect. Pet. App. A10. The court noted that, under the circumstances of this case, the debentures' subordination provision, unlike the failed institution's basic promise to pay principal and interest, represented "a covenant running from the investors to depositors and the government [and] * * * intended to benefit [them] * * * in the event that the [institution] cannot pay all its debts." *Ibid.* Thus, "[i]t would make no sense to treat repudiation of the failed [institution's] debt as though it nullified a subordination agreement designed to protect the government and the depositors in that precise eventuality." *Ibid.* Because such an interpretation would not serve the purposes of subordination, of repudiation, or of allowing the use of subordinated debt as regulatory capital, the court rejected petitioner's proposed construction of the regulations.

ARGUMENT

1. Petitioner argues primarily (Pet. 10-11, 16-22) that the RTC and the court of appeals have misinterpreted 12 C.F.R. 389.11(c) (1990)—a regulation that was adopted after the issuance of Santa Barbara Savings' subordinated debentures (see 53 Fed. Reg. 25,129, 25,133 (1988)), and that was repealed shortly after the repudiation and claim at issue in this case

(see 55 Fed. Reg. 46,495 (1990)).[3] Section 389.11(c) provided that if the repudiation of an executory contract gave rise to a claim for damages, that claim should be "classified as a claim that has accrued and become unconditionally fixed on or before the date of default, and not as an administrative expense of the receiver." It therefore ensured that the receiver's role in deciding to repudiate a contract would not transmute the resulting claim for damages (see 12 U.S.C. 1821(e)(3)) from a claim against the assets of the failed institution into an expense of the receivership, entitled to first priority in liquidation.

Petitioner focuses on the regulation's declaration that such a claim should be treated as one that had "accrued and become unconditionally fixed on or before the date of default"—language that is also found in Section 389.11(a)(6). That language merely makes clear that the claim is to be treated, in accordance with ordinary bankruptcy principles (see pages 10-11, *infra*), as one against the estate, arising at or before the institution of the receivership, rather than as a claim against the receiver itself. As the court of appeals recognized (Pet. App. A8-A9), nothing in subsection (c) changes the fact that any claim that would otherwise take its priority from subsection (a)(6) may nonetheless fall into a lower priority tier if another subsection applies to it in more specific

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[3] The FDIC does not concede that Section 389.11(c), which was not in effect at the time the district court rendered its decision, should have been applied in resolving this case. See Pet. App. A7. The court of appeals did not reach that issue (*ibid.*), and we do not address it here. The possibility that the regulation petitioner asks this Court to reinterpret is not even properly at issue is, however, another factor that counsels against review in this case.

terms. See, *e.g.*, 12 C.F.R. 389(a)(8) (1990) (assigning lower priority to federal income tax claims).

The court of appeals held only that a claim for damages measured by the principal amount of subordinated debentures, and interest accrued through the date the receiver was appointed, was covered by the specific provision in Section 389.11(a)(9) for subordinated claims, which supersedes the more general provision of Section 389.11(a)(6). That construction of the regulation does not conflict with any decision of this Court or of another court of appeals. In the absence of such a conflict, the court's straightforward interpretation of a repealed regulation does not warrant further review by this Court.

2. Petitioner argues (Pet. 12, 15-16, 19-20, 22-23) that, even if Section 389.11(c) does not apply, the decision below conflicts with settled principles governing the repudiation of executory contracts in bankruptcy, and with this Court's decision in *NLRB* v. *Bildisco & Bildisco*, 465 U.S. 513, 531-532 (1984). Petitioner contends that the decision below improperly allows a federal receiver to repudiate the agreements that otherwise govern a failed institution's obligations to the holders of its debentures, while enforcing the holders' agreement to subordinate the debt.

Petitioner misapprehends the nature of repudiation. Repudiation by a receiver does not void a contract ab initio; rather, it breaches the contract in a particular way that has special legal consequences. In the bankruptcy context, repudiation "constitutes a breach of the contract which relates back to the date immediately preceding the filing of a petition in bankruptcy." *Bildisco*, 465 U.S. at 530; see also, *e.g.*, *In re Brady, Texas, Muncipal Gas Corp.*, 936 F.2d

212, 214 (5th Cir.), cert. denied, 502 U.S. 1013 (1991); *In re Western Real Estate Fund, Inc.*, 922 F.2d 592, 595 (1990), modified on other grounds *sub nom. Abel* v. *West*, 932 F.2d 898 (10th Cir. 1991). "Damages * * * that result from the rejection of an executory contract" are therefore treated as damages for a pre-petition breach, and they must be handled through the normal administration process as claims against the estate (rather than, for example, as claims against the trustee or debtor-in-possession); they remain, however, damages "on the contract." *Bildisco*, 465 U.S. at 531; see *Western Real Estate Fund*, 922 F.2d at 595.

The same principles apply here. The estate of a failed thrift remains contractually liable for amounts already due under a contract up to the date the receiver is appointed or, in some cases, the date of the repudiation. See, *e.g.*, *Unisys Fin. Corp.* v. *RTC*, 979 F.2d 609, 611 (7th Cir. 1992); *RTC* v. *CedarMinn Bldg. Ltd. Partnership*, 956 F.2d 1446, 1449 (8th Cir.), cert. denied, 506 U.S. 830 (1992); *Northwest Racquet Swim & Health Clubs, Inc.* v. *RTC*, 927 F.2d 355, 360 n.14 (8th Cir.), cert. denied, 502 U.S. 815 (1991); compare 12 U.S.C. 1821(e)(4)(B)(iii) (lessor of repudiated lease has a claim for all amounts in arrears as of the date of repudiation) with 12 U.S.C. 1821(e)(3)(A)(ii) (repudiation damages are generally determined as of date of appointment of receiver); see also *Bildisco*, 465 U.S. at 531 (debtor-in-possession assumes quantum meruit liability for contract benefits received pending acceptance or repudiation of contract). Claims for damages arising from repudiation of the contract are treated as claims for a breach that occurred just prior to the appointment of the receiver. Compare 12 C.F.R. 389.11(c) (1990) (providing that damages for repudiation are not

administrative expenses, but relate back to date of default) with *Bildisco*, 465 U.S. at 531-532 (if debtor-in-possession assumes contract, expenses and liabilities incurred become administrative expenses). The damages in question are measured, like any other damages for breach of contract, on the basis of the contract itself. Compare, *e.g.*, *Western Real Estate Fund*, 922 F.2d at 595; *In re Audra-John Corp.*, 140 B.R. 752, 757-758 (D. Minn. 1992).

In this case, the debentures and the trust indenture provided that the amounts due under them were to be subordinated to the claims of general creditors, and that the subordination would "in no way be affected, modified, waived or revoked by the occurrence of any Event of Default," including the appointment of a receiver. Indenture § 4.02, at 24. That subordination is "the priority specified in the written instruments that evidence" petitioner's claim, 12 C.F.R. 389.11(a)(9) (1990), and nothing in the general law of repudiation, or in any of the cases cited by petitioner, requires that Santa Barbara's bondholders be relieved of their subordination covenant for purposes of calculating contractual damages arising from an event of default of a sort that was clearly contemplated by the parties' original agreement.

3. Petitioner contends (Pet. 10-14) that the decision below conflicts with this Court's decision in *O'Melveny & Myers* v. *FDIC*, 114 S. Ct. 2048 (1994), with cases that stand for the propositions that an agency must abide by its own regulations and that a statute's or regulation's plain language is not to be disregarded in order to further a court's view of the drafters' overall purpose, and with the Second Circuit's decision in *RTC* v. *Diamond*, 45 F.3d 665, cert.

denied, 115 S. Ct. 2609 (1995). There is no substance to any of the asserted conflicts.

In *O'Melveny*, this Court held that a court should not create a special rule of federal common law to decide cases that would otherwise have been governed by state law, where Congress had enacted a detailed statutory scheme under which, for such purposes, the federal receiver merely "step[ped] into the shoes" of a failed thrift. See 114 S. Ct. at 2054. The court of appeals in this case created no special federal rule of decision to displace state law, but rather interpreted a federal regulation, reaching a result that is fully consistent with principles of repudiation drawn from general federal bankruptcy law. Nothing in *O'Melveny* suggests a contrary result.

Petitioner's reliance on cases that require adherence to the substance of agency regulations, or to specific language in such regulations rather than to a court's more general conception of their purpose, is equally unavailing. As discussed above, neither the RTC nor the court of appeals disregarded the regulation on which petitioner relies: to the extent that that regulation applies in this case (see note 3, *supra*), they merely adopted a different interpretation of that regulation from the one that petitioner would prefer. In accepting the RTC's interpretation, the court of appeals found it persuasive that "the purpose of subordination and the purpose of repudiation would be defeated" if the court adopted the contrary construction urged by petitioner. Pet. App. A10. However, the interpretation the court adopted does no violence to the language of the regulation; and within that limitation, the court surely did not err by taking the regulation's purpose into account in deciding how its language should be construed.

Finally, nothing in the decision below conflicts with the Second Circuit's decision in *Diamond*. That case held that 12 U.S.C. 1821(e)(1) authorized the RTC to repudiate burdensome leases that were subject to state and local rent control regulations, and that federal law further preempted state-law protection against eviction to the extent such preemption was necessary to effectuate the repudiation. The court's decision rested on its conclusion that the rent regulations, while extensive, did not abrogate the contractual nature of the landlord-tenant relationship, which was founded on a "contract" or "lease" within the meaning of Section 1821(e)(1).

In this case there is no question about the contractual nature of the underlying obligation, or the receiver's power to repudiate it. The court of appeals' holding with respect to the specific consequences of that repudiation depends on the application of the federal priority regulations and the terms of the underlying contract, not on the nature of state regulation of that contract or the federal preemption of non-contractual state-law rules. There is very little relationship between this case and *Diamond*, and there is no conflict between the courts' decisions.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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